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SUBJECT: BRAZIL: NEC Hubbard and BNDES Luciano Galvao Coutinho
October 11, 2007

BANCO NACIONAL DE DESENVOLVIMENTO ECONOMICO E SOCIO (BNDES):

¶1. (U) When NEC Director Hubbard, DPA/DNSA Dan Price and Ambassador Sobel met with BNDES President Luciano Galvao Coutinho on October 11 in Brasilia, Galvao began by providing brief historical background about BNDES. BNDES was established in 1952 to promote the expansion of capital-intensive industries believed to be of strategic importance to Brazil's national economic development - e.g., mining, heavy industry, and petroleum. Due to Brazil's historically high rate of inflation, the development of market-based lending was extremely limited (e.g., average tenors for most market-based lending were typically 2-3 months). In contrast, BNDES's loan portfolio extended out many years and provided a stable capital source for key industries. Over time, BNDES's mandate evolved and its lending has become more focused on poverty reduction and social development objectives. Galvao stated that BNDES has assumed much more of a commercial orientation in recent years and now has several units - for example, in the areas of project finance and investment banking - whose chief mandate is to maximize profits. Total reported BNDES assets are currently 200 billion BRL, its weighted capitalization ratio is 12.5%, and H1-07 profits were 4 billion BRL. The government of Brazil remains BNDES' sole owner.

¶2. (U) Galvao noted for sources of BNDES financing: (1) periodic capital injections via the Ministry of Finance (much more important in past years than at present), (2) a federal government unemployment fund from which BNDES is allowed to borrow at non-market rates, (3) an internal investment banking unit that generates profits which are partially retained and which help cross-subsidize other units, (4) revenues from its non-investment bank units which are an additional source of earning retentions. Interest rates that BNDES charges are set by Brazil's National Monetary Council (consisting of Central Bank, Finance Ministry, and Planning Ministry).

INFRASTRUCTURE:

¶3. (U) Galvao spoke broadly about business areas BNDES now hopes to develop. He noted interest in developing cross-country infrastructure projects that will promote economic integration among South American countries. He recognized this issue as a priority for Lula and said BNDES has been working with IDB and has begun a conversation with the World Bank on infrastructure partnerships. He noted that President Lula, in his meeting that day with all Brazil's Latin American Ambassadors, planned to focus on regional integration.

¶4. (U) However, Galvao cautioned that BNDES functions under the constraint that, as a public bank, BNDES was not permitted to finance projects that do not involve Brazilian companies or use Brazilian good. He stressed this was an important qualification that underlines the need for IDB and World Bank participation in such projects as well. He added that at President Lula's direction, BNDES is creating a special fund for project development. BNDES is also focused on project development and lending inside Brazil. Galvao underlined that Brazil needs coordinate with IDB and IFC to identify good sound projects "of which we have a lack." "We need a number of sound macro-infrastructure projects that integrate countries. We think exposure to trade leads to stability in the

region, for example if a land-blocked country can get a route to a port." Galvao felt BNDES could help either by offering concessionary loans or by identifying useful projects. He indicated that, again at Lula's direction, BNDES had created a special team to work on this issue.

¶5. (U) Galvao summarized the challenges were a) good projects and b) liquidity/risk. He noted that there is never a problem loaning to low-risk countries' projects, but when a country is high-risk, there needs to be developed a kind of risk insurance that is not too expensive for these countries.

¶6. (U) Galvao noted BNDES was "instrumental" in Brazil's recent road concession and that it developed "the entire model underlying this transaction." He also noted the BNDES is contributing to development of a project to use sugarcane for electricity which the bank would finance on special terms. He added that eighty ethanol projects are funded by the bank, all with the possibility to produce electricity in the future, an area BNDES is interested in supporting given the potential electricity crisis in the future the country faces.

INVESTMENT CLIMATE:

¶7. (SBU) DPA Price queried Galvao on the investment climate in Brazil, noting there is a perception of legal and regulatory risk. He highlighted the potential benefits of arbitration. Galvao acknowledged he was highly aware of these difficulties, but believed institutional progress is being made. Galvao stated that political risk in Brazil is likely to remain low for the next twenty years, and noted that "the PT is the party farthest to the left that Brazil is likely to elect for the foreseeable future." However, he stated that regulatory risk remains high - in particular, he noted that environmental regulations among some state governments remain a key barrier to new project finance lending. Galvao noted that many regulatory agencies were created after privatization (which he said had been done in a very "improvised way.") and needed to improve technical capability. He noted civil aviation regulatory structures in particular had not been able to cope well with increased growth and demand.

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¶8. (U) This message was jointly produced by Treasury Sao Paulo and Econ Brasilia.

¶9. (U) Delegation cleared this message.